

SECOND QUARTER 2018 REVIEW AND OUTLOOK

EXECUTIVE SUMMARY

Portfolio Themes

- **Quality Tilt:** As the bull market progresses, we prefer equities with stronger balance sheets and consistent margins.
- **Overweight to Information Technology:** The Information Technology sector is heavily skewed toward large, high-quality firms—a segment we expect to outperform in the later stages of a bull market. The sector should also benefit from robust global IT spending driven by the growing demand for products and services related to mobile, cloud computing and the “Internet of Things.”
- **Overweight to Health Care:** Health Care should benefit from increasing investor preferences for larger, higher quality companies with long term growth prospects. Within the sector, larger Pharmaceutical firms are offsetting key patent expirations through pipeline development, M&A, licensing and rapid Emerging Markets growth.

Market Outlook

- **Growing Investor Confidence:** Investor optimism typically increases as a bull market matures. Recent correction angst notwithstanding, US sentiment has improved but is not yet euphoric. Meanwhile, growing optimism in the US remains unmatched by European investors.
- **Strong Economic Drivers:** In both developed and emerging markets, economic drivers remain strong. We believe these fundamentals will come to the forefront as sentiment improves.
- **European Leadership:** As euroskeptic fears fizzle and renewed gridlock reduces legislative risk, Europe should outperform for the remainder of 2018.

The MSCI All Country World Index finished the second quarter up slightly amid evolving fears.ⁱ Concerns over rising yields, tariffs, slower economic growth and politics alternated headlines as this correction's alleged cause. Fluctuating fear is a classic correction trait, as investors anxious about volatility seek to justify drops and rationalize taking action. In a bear market, the opposite occurs where investors cling to positives and dismiss reasons more downside awaits. This sentiment backdrop, combined with underappreciated positive political and economic drivers, suggests that a bear market isn't likely. Where equities go immediately from here is difficult to predict, but we continue to believe the bull market should eventually resume with intensity, delivering strong returns.

At the end of Q2, headlines returned to tariffs as a threat to equities. While no tariff is good, we believe those discussed to date lack the size and surprise to derail global growth. President Trump has recently approved tariffs on approximately \$85 billion in imported goods and he has threatened tariffs on \$408 billion more. With tariff rates ranging from 10% to 25%, the maximum annual impact

if Trump enacts all threatened tariffs would be \$81.5 billion—approximately 0.4% of the US's \$19.4 trillion GDP.ⁱⁱ However, this is an unlikely scenario. Unilateral tariffs are easy for exporters to avoid because brokers can reroute goods through third-party nations for a small fee. Hence their impact is likely small. Additionally, the tariffs could also be the president's way of rallying his supporters before the US midterm elections—threats he can walk back, perhaps after “winning” apparent concessions from trading partners.

Amid concerns about tariffs, some investors disregard a strong global economy. GDP grew in Q1 in the US, UK and eurozone. US loan growth has accelerated, funneling more capital to businesses and households to spend and invest. Business surveys in the US, Britain and the eurozone show output and new business are rising. While rising slightly, inflation and inflation expectations remain moderate, extending a Goldilocks-style economy globally. The European Central Bank announced plans to end quantitative easing, an unheralded positive that should spur loan growth. If markets were zooming, we suspect pundits would cheer an echo of the mid-to-late 1990s, when

ⁱ Source FactSet, as of 07/02/2018. MSCI All Country World Index return with net dividends, 03/31/2018 – 06/29/2018.

ⁱⁱ Source: Office of US Trade Representative, White House and US Bureau of Economic Analysis, as of 06/28/2018.

stocks enjoyed years of solid returns before Tech Bubble euphoria took hold. However, in our opinion, sideways volatile markets and fearful headlines blind some investors, creating room for positive surprise—bullish.

Global politics also remain favorable, with gridlock entrenched throughout the developed world. Despite high-profile political turnover in Spain and Italy, which we will discuss in the full Review & Outlook, these countries still have a minority government and weak coalition, respectively—a climate for inaction. German Chancellor Angela Merkel's coalition is unstable, as is UK Prime Minister Theresa May's minority government. The twin issues of Brexit and migration monopolize politicians' attention on both sides of the English Channel, crowding out major legislation. About the only significant measure passed in Q2 was Britain's bill to add a third runway at Heathrow airport. Overall, legislative risk seems low.

Meanwhile, US politicians are preoccupied with midterm campaigning. Though the recent retirement of Supreme Court Justice Anthony Kennedy could contribute to the heated campaign rhetoric, we expect the election's outcome to prove duller than today's sensational headlines suggest. An updated coverage in the full Review & Outlook will be provided but, in short, whether we end up with a small Democratic majority, small Republican majority or split Congress, gridlock should prevail. This should usher in the US political cycle's sweet spot: the 87% Miracle. As we will detail in the full Review & Outlook, US equities have historically been positive 87% of the time in each of the three post-midterm quarters which is well above the average quarter.ⁱⁱⁱ The tailwinds of gridlock and falling uncertainty are powerful.

In Emerging Markets, mainland Chinese stocks tumbled as Trump's harsh new tariff threats alarmed investors. Consistent with our view for the US, we don't believe the impact of proposed tariffs is large enough to spark an actual hard landing in the second largest global economy.^{iv} Not only would the actual tariff payments amount to a sliver of annual GDP, if enacted, but we believe they are easily avoidable. For example, consider the tariff on US soybean imports. It is highly unlikely Chinese importers end up paying this, as they can easily buy from other nations, like Brazil, where tariffs don't apply.

Furthermore, with recent strength of the US dollar driving volatility in some EM currencies, higher oil prices and US 10-year treasury yields close to 3%, concerns around emerging markets have been reignited. Though some countries, like Turkey, face challenges specific to their underlying markets, we don't believe the structural conditions of EM as a whole suggest a broader contagion effect. Still-strong economic fundamentals coupled with cooler investor sentiment suggest EM countries probably don't face significant downside from here as broad global growth continues pulling along most EM economies, defying fears of a slowdown.

We still believe global equities should have a strong year. Returns during US midterm-year Q3s are more variable, and we believe volatility will persist before the 87% Miracle starts. Crucially, however, we don't believe this is a bear market. As we will discuss more in the full Review & Outlook, we continue scouring for reasons we could be wrong—surprising, fundamental negatives with the power to erase a few trillion from global GDP and turn this correction into a bear market. However, currently we don't see any. Rather, we believe fundamentals favor a strong second half and beyond.

ⁱⁱⁱ Source: Global Financial Data, Inc., as of 06/15/2018. S&P 500 Index total return, 12/31/1925 – 03/31/2018.

^{iv} Source: IMF, based on nominal gross domestic product, as of 04/30/2018.

Should you have any questions about any of the information in the Second Quarter 2018 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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